STAFF PAPER

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IFRS® Interpretations Committee meeting

Project	**Lack of exchangeability (IAS 21)**
Paper topic	Lack of exchangeability—Disclosures requirements

CONTACT(S)	Vincent Louis	vlouis@ifrs.org	+44 (0) 20 7246 6470
	Jawaid Dossani	jdossani@ifrs.org	+44 (0) 20 7332 2742

Purpose of the paper

1. Agenda Paper 14B for this meeting discusses how an entity determines the exchange rate for a currency that is subject to a lack of exchangeability. This paper presents our analysis and recommendations on the disclosures an entity should provide when exchangeability is lacking. Our analysis in this paper builds on the analysis and recommendations in Agenda Paper 14B.

Structure of the paper

2. This paper includes our analysis (paragraphs 4–25) and recommendations (paragraphs 26–27).

3. This paper has two appendices:

   (a) Appendix A—Committee feedback on staff preliminary views; and

   (b) Appendix B—extract from Agenda Paper 8B for the November 2018 Committee meeting.

Staff analysis and recommendations

Overall approach for disclosure requirements

4. At the November 2018 Committee meeting, our preliminary view was that an entity should (a) provide specific disclosures when a currency is subject to a long-term lack of exchangeability, and (b) not be required to provide specific disclosures when exchangeability is temporarily lacking.

5. As explained in Agenda Paper 14B, we think it is not necessary to distinguish between temporary and long-term lack of exchangeability in any amendment. Consequently, we have reconsidered our analysis with regards to disclosure.

6. As explained in Appendix A to this paper, Committee members generally agreed that an entity should provide specific disclosures when exchangeability is lacking and the entity estimates the spot exchange rate (spot rate). However, some Committee members suggested that any amendment set out disclosure objectives that an entity would apply in providing useful information.

7. Agenda Paper 8B for the November Committee meeting (the November agenda paper) also identified disclosure requirements that already exist in IFRS Standards (for example, in IFRS 7 *Financial Instruments: Disclosures* and in IFRS 12 *Disclosure of Interests in Other Entities*) that could be relevant when exchangeability is lacking. Our discussion in this respect is included in paragraphs 38–52 of the November agenda paper—for ease of reference, Appendix B to this paper reproduces those paragraphs. However, those requirements were not necessarily developed to address circumstances in which exchangeability is lacking, and thus, it might not always be clear which requirements are applicable when exchangeability is lacking. Accordingly, we think any amendment should specify the disclosures an entity would provide when exchangeability is lacking (including applicable requirements in other IFRS Standards).

8. Accordingly, we recommend that any standard-setting set out disclosure objectives and link any proposed disclosure requirements to those objectives.

9. As part of its *Disclosure Initiative—Targeted Standards-level Review of Disclosures*, the Board tentatively decided in 2018 to develop guidance that it would use when developing and drafting disclosure requirements[1]. In our view, some aspects of this draft guidance could help in developing disclosure requirements for this project.

10. The draft guidance recommends that the Board develop:

    (a) high-level disclosure objectives within individual Standards. Those disclosure objectives would prompt preparers to consider whether the overall information provided in complying with the specific disclosure objectives and requirements of a Standard meets overall user information needs.

    (b) specific disclosure objectives that would underpin any disclosure requirements. Those specific disclosure objectives would provide a more granular application of the high-level disclosure objectives. They would also prompt entities to apply judgement in assessing whether each piece of information is material to their financial statements and whether the information provided meets specific user information needs.

11. We have applied those two aspects of the draft guidance to develop our analysis and recommendations on disclosure requirements:

    (a) paragraphs 12–14 present our analysis and recommendation regarding a high-level disclosure objective; and

    (b) paragraphs 15–25 set out our analysis and recommendations regarding specific disclosure objectives.

High-level disclosure objective

12. A lack of exchangeability of a currency results in an entity not being able to observe the spot rate. Applying our recommendations, an entity would estimate the spot rate at the reporting date. The exchange rate used could materially affect many entities' financial statements. In the absence of a disclosure objective, there is a risk that users of financial statements might not be able to compare entities' financial position

[1] The latest draft guidance can be found in [Agenda Paper 11A] for the September 2018 Board meeting.

and performance—this is because estimating the spot rate in this situation could require significant judgement and assumptions. Accordingly, we think any overall disclosure objective should capture how a lack of exchangeability affects an entity's financial statements at the reporting date.

13. In addition, applying our proposed definition for exchangeability (and a lack thereof), a currency's lack of exchangeability would reflect circumstances in which an entity is exposed to particular risks. Those risks could result in potential variability of cash flows ultimately derived from assets and liabilities denominated in the currency that is not exchangeable. We think users of financial statements would be interested in understanding those risks and their effect on an entity's future cash flows.

14. Accordingly, we think the overall disclosure objective for any amendment could be set out as follows:

> An entity shall disclose information that enables users of financial statements to understand how a currency's lack of exchangeability affects, or is expected to affect, an entity's financial performance, position and cash flows.

Specific disclosure objectives

Spot rate used

15. A currency's lack of exchangeability results in an entity being unable to use an observable spot rate in applying the requirements in IAS 21. IAS 21 does not require an entity to disclose the exchange rates used at the reporting date. In our view, given the nature of a lack of exchangeability, any amendment should require an entity to disclose information about the spot rate used in those circumstances.

16. Accordingly, we think any amendment could include a specific disclosure objective as follows:

> When a currency is subject to a lack of exchangeability, an entity shall disclose information about the spot exchange rate used.

17. We think an entity should disclose the following information when necessary to meet this specific disclosure objective:

(a) the spot rate used, and

(b) the nature of this spot rate (ie a rate developed using an estimation technique or an observable rate that approximates the spot rate at the reporting date—see paragraphs 21–46 of Agenda Paper 14B for this meeting);

Estimation process

18. As explained in paragraph 2.18 of the 2018 *Conceptual Framework for Financial Reporting*, a representation of an estimate can be a faithful representation if (i) the amount is described clearly and accurately as being an estimate, and (ii) the nature and limitations of the estimation process are appropriately described.

19. Accordingly, we think that any amendment should include a specific disclosure objective in relation to the description of, and uncertainties about, the estimation process. Such a specific disclosure objective could be drafted as follows:

> When an entity uses an estimated spot exchange rate, the entity shall disclose qualitative information about the estimation process and quantitative information about the uncertainties pertaining to that estimation process.

20. We think an entity should disclose the following information when necessary to meet this specific disclosure objective:

(a) a description of the estimation technique and the main inputs used; and

(b) a sensitivity analysis showing how changes in the main inputs used could affect the spot rate.

21. Consistent with our analysis in paragraphs 38–52 of the November agenda paper (see Appendix B to this paper), we think an entity might provide that information (or a part of it) applying paragraphs 125–133 of IAS 1 *Presentation of Financial Statements*. We think it would be helpful to provide a cross-reference to the applicable requirements in IAS 1.

Risks

22. As discussed in paragraph 13 above, an entity is exposed to risks when a currency is subject to a lack of exchangeability. We have identified below some examples of those risks:

    (a) liquidity risk[2]:

        (i) an entity has financial assets (such as cash and cash equivalents) denominated in a currency that is not exchangeable with the entity's functional currency. In such circumstances, at the reporting date, the entity is unable to use those assets to settle liabilities denominated in its functional currency.

        (ii) an entity has assets denominated in its functional currency and liabilities denominated in a currency that is not exchangeable. In such circumstances, there is a risk that the entity will encounter difficulties in meeting obligations associated with its financial liabilities.

        (iii) a reporting entity has a foreign operation whose functional currency is not exchangeable. In such circumstances, the entity would be unable to access or use the cash balances of the foreign operation to settle liabilities of the group.

    (b) currency risk[3]: an entity estimates the exchange rate for financial assets and liabilities. This rate may be significantly different from the rate that will apply when exchangeability is restored, and the assets and liabilities are settled. In such circumstances, the entity is exposed to currency risk.

23. We think that any amendment should include a specific disclosure objective in relation to risks. Such a specific disclosure objective could be drafted as follows:

    > An entity shall disclose qualitative and quantitative information about the nature and extent of risks arising from a currency that is subject to a lack of exchangeability.

[2] Appendix A to IFRS 7 defines liquidity risk as the 'risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset'.

[3] Appendix A to IFRS 7 defines currency risk as 'the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates'.

24. We think an entity should disclose information that is similar to the information required in IFRS 7 with respect to risks. Accordingly, we think an entity should disclose the following information when necessary to meet this specific disclosure objective:

    (a) qualitative information about each type of risk and how each risk has changed from the previous reporting period;

    (b) quantitative information about its exposure to each risk arising from the currency's lack of exchangeability; and

    (c) sensitivity analysis showing how (i) the statement of comprehensive income, and (ii) equity would have been affected by a reasonably possible change in the exchange rate at the reporting date.

25. Consistent with our analysis in paragraphs 38–52 of the November agenda paper (see Appendix B to this paper), we think an entity might provide that information (or part of it), applying the disclosure requirements in IFRS 7 and IFRS 12. We think it would be helpful to provide a cross-reference to the applicable requirements in IFRS 7 and IFRS 12.

Staff recommendations

26. We recommend that any amendment set out disclosure objectives for this project. In particular, we recommend any amendment include a high-level disclosure objective requiring an entity to disclose information that enable users of financial statements to understand how a currency's lack of exchangeability affects, or is expected to affect, the entity's financial performance, position and cash flows.

27. We also recommend that any amendment specify three specific disclosure objectives to provide a more granular application of the high-level disclosure objective described above. Those objectives would require an entity to disclose:

    (a) information about the spot rate used. We recommend that an entity disclose the following information when necessary to meet this specific disclosure objective:

        (i) the spot rate used, and

(ii) the nature of this spot rate.

(b) qualitative information about the estimation process and quantitative information about the uncertainties pertaining to that estimation process. We recommend that an entity disclose the following information when necessary to meet this specific disclosure:

(i) a description of the estimation technique and the main inputs used; and

(ii) a sensitivity analysis showing how changes in the main inputs used could affect the spot rate.

(c) disclose qualitative and quantitative information about the nature and extent of risks arising from a currency that is subject to a lack of exchangeability. We recommend that an entity disclose the following information when necessary to meet this specific disclosure objective:

(i) qualitative information about each type of risk and how each risk has changed from the previous reporting period;

(ii) quantitative information about its exposure to each risk arising from the currency's lack of exchangeability; and

(iii) a sensitivity analysis showing how the statement of comprehensive income and equity would have been affected by a reasonably possible change in the exchange rate at the reporting date.

Question for the Committee

Does the Committee agree with our recommendations as set out in paragraph 27 of this paper? Does the Committee have any other suggestion?

Appendix A—Committee feedback on staff preliminary views

Preliminary view

A1. Our preliminary view was that:

(a) no specific disclosure requirements would be necessary when a currency is subject to a temporary lack of exchangeability; and

(b) an entity would be required to disclose particular information about the estimation process (for example, a description of the estimation technique applied and the main inputs used) when a currency is subject to a long-term lack of exchangeability.

Committee's feedback

Long-term lack of exchangeability

A2. Committee members generally agreed with our preliminary view that:

(a) the disclosure requirements in IFRS 7 enable users of financial statements to understand the nature and extent of the currency risk to which an entity is exposed.

(b) the disclosure requirements in IFRS 12 are relevant to an understanding of any significant restrictions on an entity's ability to access or use assets and settle liabilities of the group, or in relation to its joint ventures and associates.

A3. Accordingly, the Committee agreed that any additional disclosure requirements should relate to the estimation process and any related uncertainties. Some Committee members suggested requiring an entity to also disclose a sensitivity analysis of the main inputs used in the estimation process.

A4. However, some Committee members asked whether any amendment should:

(a) prescribe a list of required disclosures; or

(b) set out disclosure objectives with some indicators on the types of disclosures that might help the entity meet those objectives.

Temporary lack of exchangeability

A5. Some Committee members and observers disagreed with our preliminary view and said an entity should disclose:

(a) that the currency is subject to a temporary lack of exchangeability;

(b) the first subsequent rate at which exchanges could be made; and

(c) the exposure of the entity to the currency that is subject to a temporary lack of exchangeability.

How we responded to the Committee's feedback

A6. Our analysis in paragraphs 4–25 of this paper incorporates feedback from the Committee.

Appendix B—extract from Agenda Paper 8B for the November 2018 Committee meeting

This appendix reproduces paragraphs 38–52 of the Agenda paper 8B for the November Committee meeting.

Disclosures

38. In this section we consider whether any specific disclosure requirements are needed for when there is a lack of exchangeability. Our analysis considers temporary and long-term lack of exchangeability separately.

Long-term lack of exchangeability

39. In this situation, we think:

(a) the entity is exposed to risks because the currency is subject to a long-term lack of exchangeability. Accordingly, users of financial statements (users) may be interested in having information about the entity's exposure; and

(b) applying our preliminary views, an entity would estimate a spot exchange rate—users may be interested in information about the estimation process and any uncertainties relating to that process.

40. Before assessing whether the Committee should add specific disclosure requirements to IAS 21 in this regard, we first considered existing requirements that would relate to these matters and then considered any additional disclosures that could be helpful.

Information about risks

41. IFRS 7 *Financial Instruments: Disclosures* applies to financial instruments. Paragraphs 31–42 of IFRS 7 specify disclosure requirements on the nature and extent of risks arising from financial instruments. Paragraphs 40–42 of IFRS 7 set out disclosure requirements for market risk.

42. Appendix A to IFRS 7 specifies that currency risk is a type of market risk and defines it as 'the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates'.

43. Paragraph B23 of Appendix B to IFRS 7 states:

> Currency risk (or foreign exchange risk) arises on financial instruments that are denominated in a foreign currency, ie in a currency other than the functional currency in which they are measured. For the purpose of this IFRS, currency risk does not arise from financial instruments that are non-monetary items or from financial instruments denominated in the functional currency.

44. Accordingly, the disclosures requirements in IFRS 7 enable users to understand the nature and extent of currency risk arising from financial instruments when:

    (a) an entity reports foreign currency transactions in the functional currency; and

    (b) those transactions relate to financial instruments that are monetary items.

45. In addition, in its September 2018 Agenda Decision, the Committee observed that some disclosure requirements may be relevant to an understanding of an entity's financial statements when the entity has a foreign operation whose functional currency is subject to a long-term lack of exchangeability. In particular, the Committee observed that paragraphs 10, 13, 20 and 22 of IFRS 12 *Disclosures of Interests in Other Entities* require an entity to disclose the nature and extent of significant restrictions on its ability to access or use assets and settle liabilities of the group, or in relation to its joint ventures or associates.

46. In our view, the disclosure requirements discussed in paragraphs 41–45 of this paper are sufficient to help users understand a reporting entity's exposure to risk that arises from long-term lack of exchangeability. Accordingly, we think no additional disclosure requirements are necessary in this regard.

Estimating a spot exchange rate

47. Paragraphs 125–133 of IAS 1 *Presentation of Financial Statements* specify requirements applying when an entity identifies sources of estimation uncertainty. In this regard, paragraph 125 of IAS 1 states:

> An entity shall disclose information about the assumptions it makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year. In respect of those assets and liabilities, the notes shall include details of:
>
> (a) their nature, and
>
> (b) their carrying amount as at the end of the reporting period.

48. Paragraph 129 of IAS 1 provides examples of the types of disclosures an entity makes in this respect. It states:

> …Examples of the types of disclosures an entity makes are:
>
> (a) the nature of the assumption or other estimation uncertainty;
>
> (b) the sensitivity of carrying amounts to the methods, assumptions and estimates underlying their calculation, including the reasons for the sensitivity;
>
> (c) the expected resolution of an uncertainty and the range of reasonably possible outcomes within the next financial year in respect of the carrying amounts of the assets and liabilities affected; and
>
> (d) an explanation of changes made to past assumptions concerning those assets and liabilities, if the uncertainty remains unresolved.

49. While these disclosure requirements in IAS 1 are helpful, we think specific disclosure requirements would be needed when an entity estimates a spot exchange rate. This is because:

(a) experience with estimated rates for the Venezuelan Bolivar (VEF) indicates that the range of possible outcomes might be wide. In paragraph B6 of Appendix B to Agenda Paper 3 prepared for the May 2018 Committee meeting, we observed that the estimated rates used as at 30 June 2017 ranged from USD 1:VEF 2,852 to USD 1:VEF 4,302.

(b) entities might use different methods to estimate the spot exchange rates.

(c) users may need information that would enable them to assess any measurement uncertainty in the estimation process.

50. In our view, an entity should disclose:

(a) a description of the circumstances that resulted in a long-term lack of exchangeability;

(b) the estimated spot exchange rate;

(c) a description of the estimation methodology and the key inputs used; and

(d) the foreign exchange position on the currency.

Temporary lack of exchangeability

51. We think the existence of a temporary lack of exchangeability does not necessitate any disclosure requirement. This is because, in such a situation:

(a) the risk of being unable to exchange a currency no longer exists when the financial statements are authorised for issue; and

(b) the entity uses an observable rate; it does not estimate the rate.

Conclusion

52. Based on our analysis, when there is a long-term lack of exchangeability, we think an entity should be required to disclose the information listed in paragraph 50 of this paper. No specific disclosures should be required when there is a temporary lack of exchangeability.